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The Investment War With China

Part one of this broader examination takes stock of Chinese stocks and the ramifications of delisting.

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The United States-China trade war began in 2018 and has dominated headlines ever since. Over time, the trade war has evolved into a broader economic war involving tech (with limits on the ability of U.S. companies to supply Chinese companies such as Huawei with parts), inward foreign direct investment (FDI) (with stricter reviews of Chinese money flowing into strategic sectors or companies with vital assets), and secondary sanctions (with new or intensified actions against Chinese companies dealing with countries, like Iran, that face direct American sanctions). Until recently, portfolio investment has not been thrust onto the battlefield.

In late September, however, news broke that the administration of U.S. President Donald Trump was contemplating delisting Chinese companies from U.S. stock exchanges such as the New York Stock Exchange (NYSE) and NASDAQ. These stories materialized roughly three months after Senator Marco Rubio proposed legislation that would require, under threat of delisting, listed Chinese companies to permit on-site audits in China or provide audit information that the Chinese government repeatedly has refused to allow under the argument that such audits would constitute violations of Chinese sovereignty or that the disclosure of audit information would reveal state secrets. For proponents, the political logic behind delisting Chinese stocks is that the capital from listings is supplying funding to America's peer political and economic competitor.

Former White House senior advisor Steve Bannon provocatively charged, "We have unlimited financing for the Chinese Communist Party, and their front organizations… The Frankenstein monster that we have to destroy is created by the West. It's created by our capital." In tandem with the commotion surrounding the potential delisting of Chinese stocks, NASDAQ has been moving to restrict initial public offerings (IPOs) by small Chinese companies. NASDAQ's driving motivation does not seem to be the Trump administration or pressure, but rather because listings like 111 Inc., Puxin Ltd., and Dogness have low liquidity, volatility, and lack appeal to large institutional investors. Still, some Chinese observers view it as just yet another manifestation of the economic war the U.S. is waging on China.

Recent reports suggest that there are between 150 to 200 Chinese companies listed on the NYSE, American, and NASDAQ exchanges. According to various reports, these companies have a market capitalization running between $1.2 and $1.8 trillion. Of that, a very large share consists of the stocks of just three companies: Alibaba (nearly 35 percent of the total), PetroChina (approximately 13 percent), and China Life (roughly 8 percent). Other prominent stocks that would be affected are Baidu Inc., Ctrip.com, and JD.com. Per Refinitiv, a supplier of financial market data as well as data analysis tools, Chinese companies have raised over $70 billion in the U.S. stock market since 2000, of which $46.1 billion has been raised since 2013 through new listings. In recent years, Chinese companies have raised considerable amounts of money on U.S. stock exchanges. In 2018, they raised $8.6 billion. The above shows that we are not talking about small sums of money, from either the American or the Chinese standpoint, when debating the issue of delisting.

To evaluate the desirability of a sweeping U.S. delisting policy, we need to consider the political and economic gains and losses associated with it. In terms of economic downsides, five points deserve consideration. First, in the absence of countervailing factors, such a policy might undermine American stock markets by decreasing investor confidence, politicizing markets, and sparking capital outflows. Second, such a policy could drive listings to other markets such as Hong Kong, London, and Shanghai's STAR market. Still it is not entirely clear how hard the hit would be given the current tendency for Chinese companies to list elsewhere. Third and related to the second point, over the longer term, a hostile stance toward Chinese listings and the politicization of U.S. stock markets likely will fuel the development of competitor markets. Fourth, investment options will decrease for U.S. investors. And fifth, forced stock delistings could lead to Chinese retaliation.

In terms of economic benefits, three arguments might be made. One is that delistings will increase pressure on Beijing to make the kinds of changes Washington is demanding as part of its economic war against China. One should not be too sanguine about this, though, given Beijing's notable dearth of compromises to date and the lack of clarity about how seriously Chinese firms will suffer if they cannot list on American stock exchanges, especially at a time when China moving to liberalize its financial sector. Aside from this, it is uncertain if China itself actually will suffer from delisting — to give an example, Japan's Softbank apparently is one of the major holders of Alibaba stock. A second argument is that starving Chinese companies of capital will weaken the competitors of American firms. The thesis is that if they cannot list on American markets, they will lose access to the "world's deepest pool of capital," a pathway for obtaining U.S. dollars, an "acquisition currency," and a branding mechanism. Beyond this, financing costs will rise, expertise will become inaccessible, and exchange rate risk may become an issue in cases where domestic funding is used to support overseas activities. Still, the magnitude of these costs is far from pre-determined. Some Chinese firms, as noted, have other listing and funding options; others, like Alibaba, can fund operations through operations; and yet other Chinese firms actually see other exchanges as more attractive given the possibility of much higher valuations. A third is that the presence of Chinese firms in the United States will be reduced which, in turn, will weaken their ability to obtain American technology and knowledge.

As for political costs, a massive delisting might, as mentioned, provoke an escalation of the Sino-American economic war in existing realms or into new realms. It also could stigmatize the United States, especially given all that is going on with respect to American trade pacts and allies, as even more protectionist/parochial than currently believed. Beyond this, to the extent one believes such forces truly are operative and influential, it could undermine those in favor of more "liberal market principles" in China. As for political benefits, there are various potentialities. The most important one, at least to proponents, is that it might squeeze Beijing to make the kind of policy changes that Washington is demanding. Again, to date, we have no evidence this will occur. Another is to send a signal that no economic realms are off limits if countries refuse to cooperate with U.S. policy preferences. Lastly, a delisting, if applied in a selective fashion, can reinforce core stock exchange principles of oversight and transparency.

The director of one Chinese research institute opined, "China continues to open up its financial sector, while the U.S. slams its door on Chinese companies. The U.S. will trip over its own feet." It is not definite that this will occur. Still, the economic costs of delisting Chinese companies are significant and the economic benefits dubious. On top of this, the political costs are real while the political benefits, although rather unimpressive, are worth pursuing. In the final analysis, Washington needs to think very carefully about the merits of delisting all Chinese stocks.

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